THE NEED FOR SPEED AND COMMON SENSE: REWRITING § 365(c)(2) TO RECOGNIZE THE PRACTICE OF PREPETITION AGREEMENTS FOR § 364 DEBTOR-IN-POSSESSION FINANCING

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The era of the leveraged buyout (LBO) has passed, replaced by the age of the Chapter 11 filing.[1] In the 1980s, American companies engaged in a profligate exchange of debt for equity, spurred by the accessibility of capital for the acquisition and defense of corporate assets.[2] Eventually, however, huge debt servicing burdens, coupled with recent marketwide downturns and a concurrent dearth of refinancing capital,[3] proved too much for these companies to bear. Facing decreasing revenues, reduction of cash flow, and, consequently, frequent defaults on debt obliga-

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1 Notable LBOs, or highly leveraged transactions (HLTs), of publicly traded companies that have filed for Chapter 11 protection since 1988 include: Allied Stores Co., Inc., Best Products Corp., Federated Department Stores, Hillsborough Holdings, National Gypsum Co., Resorts International, Revco D.S., Inc., and Southland Corp. *See* THE BANKRUPTCY YEARBOOK AND ALMANAC 81 (Christopher McHugh ed., 1991). These eight companies represented over $24 billion in assets that were under Chapter 11 protection in 1991. Federated has since emerged from bankruptcy. *See* Laura Zinn & Michele Galen, *Short Chapter, Happy Ending*, BUS. WK., Feb. 10, 1992, at 126 (discussing the conglomerate's emergence from bankruptcy in February 1992). The newest member to join the group of LBOs which have gone bust is R.H. Macy & Co. with nearly $5 billion in assets currently under Chapter 11 protection. *See* Barbara Grady, *Macy files for Chapter 11 After Dismal Christmas*, REUTER BUS. REP., Jan. 27, 1992, *available in* LEXIS, Nexis Library, BUSRPT File.

2 *See* BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 529 tbl. 868 (1991) (indicating a growth in corporate liabilities from $7,617 billion in 1980 to $15,311 billion in 1987); *see also* Edmund Faltermeyer et al., *The Deal Decade: Verdict on the '80s*, FORTUNE, Aug. 26, 1991, at 58 (discussing a study of 1980s LBOs by Steve Kaplan and Jeremy Stein indicating that the average ratio of earnings before interest, taxes and depreciation to debt fell from 1.2 in early 1980s deals 0.7 in deals from 1986 to 1988).

3 The dearth of refinancing capital preceded the recession; there was a noticeable reduction in available capital after the United Airlines takeover which collapsed in the fall of 1989 when Citibank balked on its proposed funding. *See* Sharon Harvey, *Banks Reevaluate in Wake of UAL Fiasco*, INSTITUTIONAL INVESTOR'S BANK LETTER, Oct. 23, 1989, at 1.

tions,[4] these companies have been turning, in increasing numbers, to Chapter 11 protection from their creditors. The combination of the flood of general business Chapter 11 filings[5] and LBO failures has resulted in a dramatic alteration of the landscape of modern bankruptcy in the United States. Significantly, this increase in filings tests the ability of the Bankruptcy Code to respond to the financial and legal needs of these companies and their creditors.

Neither the general economic environment at the time of the principal redrafting of the Bankruptcy Code in 1978, nor that at the time of the 1984 amendments, bears much resemblance to the current bankruptcy environment.[6] Indeed, the current swell of corporate assets under Chapter 11 protection must have been unforeseeable to Code drafters for whom there was no hint of such an overwhelming future financial collapse.[7] And although much of the Code has demonstrated flexibility, and, to a certain extent, has been reformed by amendment where it has fallen short, the rapid changes in legal and financial approaches to the current Chapter 11 problem have demonstrated shortcomings, particularly in the area of large corporate and LBO failures.[8]

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[4] *See, e.g.*, Kathie O'Donnell, *Hard Times Will Make 1991 Default Rate the Highest in 20 Years, Moody's Says*, BOND BUYER, Dec. 20, 1991, at 3 (stating that the default rate on corporate bonds was expected to hit a twenty-year high in 1991).

[5] *See* DUN & BRADSTREET, BUS. FAILURE REC. 8 (1990) (indicating that at least 20,000 business Chapter 11 filings occurred in 1990, fewer than the nearly 25,000 filings in 1986, but substantially more than the roughly 6,000 filings in 1980).

[6] *See* Barbara A. Rehm, *A Projected Cost of Easy Credit: 1 Million Bankruptcies This Year*, AM. BANKER, Sept. 5, 1991, at 1 (citing a prediction made by the American Bankruptcy Institute that one million bankruptcy filings will be recorded in fiscal year 1991-92, a nearly threefold increase over the 360,329 filings recorded in the fiscal year beginning June 1980, and indicating that nearly six million bankruptcies have been filed since 1979). Although roughly the same number of business Chapter 11 filings occurred in both 1984 and 1990, *see* Dun & Bradstreet, *supra* note 5, at 8, the total assets in Chapter 11 bankruptcy have increased from $6.5 billion to $82.7 billion over the same period of time, a dramatic increase. Even assuming inflation of 5% annually during the period, the net present value of $82.7 billion in 1984 dollars would have been $61.7 billion, a nearly nine and one half-fold increase. *See* THE BANKRUPTCY YEARBOOK AND ALMANAC, *supra* note 1, at 30.

[7] *See* John F. Hilson & Pamela A. Kohlman, *The Financing of Chapter 11 Debtors: Some Lenders Are Seeking Them Out*, NAT'L L.J., Nov. 5, 1984, at 23 (stating a conclusion not borne out by future events, that "the rate of business failures appears to have peaked").

[8] Indeed, there has been a call by some bankruptcy lawyers to get rid of Chapter 11 altogether. *See* Wade Lambert & Milo Geyelin, *Bankruptcy Lawyers Dispute Call for Scrapping Chapter 11 Process*, WALL ST. J., Mar. 19, 1992, at B5.

Most prominent among these shortcomings has been the confusion in the Code regarding the means available for accelerating the bankruptcy process. Speed in bankruptcy is important in several ways that are accentuated by the recent increase in business failures. For courts overburdened by bankruptcy filings,[9] speedier recoveries and quicker processes mean alleviation of crowded dockets. For certain debtors,[10] a speedy emergence from bankruptcy means swifter restructuring of debt and faster return to competition in the market, as well as a reduction in legal fees.[11] Finally, for creditors, speed means, all other things being equal, lower legal costs and quicker collection on loans that are in default.[12]

The desire for speed has focused lawyers' attention on developing new methods for handling clients' bankruptcy needs. At the forefront of these methods has been the use of prepackaged bankruptcies[13] and hybrids of them.[14] Concurrently, the desire

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[9] Pending bankruptcy actions in U.S. courts have increased from roughly 660,000 in 1985 to nearly 930,000 in 1989. *See* THE BANKRUPTCY YEARBOOK AND ALMANAC, *supra* note 1, at 21.

[10] It could be argued that even in the face of the added costs some debtors may benefit from lengthy bankruptcy proceedings; if the cause of their bankruptcy was not excessive debt, but rather some combination of poor management and unsound business practices, such problems might be examined and corrected by creditors and courts. Alternatively, debtors who have high debt burdens but a sound underlying business benefit from accelerated proceedings. This latter group generally includes mature LBOs.

[11] Typically, Chapter 11 proceedings consume nearly two-and-one-half years, often damaging relations with customers and suppliers, devastating employee morale, and running up millions in legal and financial fees. *See 31-day Bankruptcy Highlights Classic "Pre-packaged" Plan*, BUS. WIRE, Jan. 28, 1992.

[12] An argument can also be made that speed reduces the ability of creditors to assess the situation and to make important judgments that might affect their ultimate return on their outstanding debt. Nevertheless, there is a gain in receiving payment sooner rather than later because of the time value of money (all else being equal).

[13] A prepackaged bankruptcy generally allows debtors to present a plan of reorganization to a statutorily defined group of creditors prepetition, and permits acceptance of the plan by those creditors prior to filing. The result is a faster bankruptcy process. For a more detailed description, see Stephen H. Case & Mitchell A. Harwood, Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Federal Declaratory Judgment Act for Instant Reorganizations, (Apr. 12, 1991) (unpublished manuscript, on file as part of a bankruptcy law symposium at New York University School of Law).

[14] *See* Dwight Cass, *Street Weighs New Bankruptcy Technique*, CORP. FINANCING WK., Sept. 9, 1991, at 1 (reporting that "[i]nvestment bankers and lawyers are closely eyeing a legal technique dubbed an 'instant bankruptcy' that would allow a company to file for and emerge from Chapter 11 simultaneously"); Cauri Coyal, *Hybrids Emerging as New Wrinkle on Prepackaged Bankruptcies*,

for speed has changed the financial sector's lending habits by focusing banks' attention on the lending opportunities created by the increasing use of these accelerated bankruptcy processes.

In particular, there has been an increased emphasis by money-center banks on postpetition lending to large failing corporations.[15] Section 364 of the Code[16] sanctions certain loans that help debtors operate postpetition[17] by providing needed working capital. These loans help stimulate emergence from bankruptcy by allowing more normal business operation in the period before confirmation of a plan for reorganization.[18] To attract creditors who would otherwise be subject to substantial risk because of the lack of assets available for security,[19] these postpetition loans are frequently superpriority loans, in which courts offer priority over all existing creditors to the new lender. For new creditors, the loans offer comparatively short maturities and high up-front fees.[20]

BONDWEEK, May 13, 1991, at 1 (reporting predictions that "[f]inancially troubled companies that cannot file prepackaged bankruptcies will increasingly turn to hybrid or partial prepacks as a way of speeding up and cutting the costs of reorganizing under Chapter 11").

[15] *See* Karen Padley, *Chemical Bank Leads in Loans to Ailing Companies*, INVESTOR'S DAILY, Sept. 13, 1991, at 1.

[16] 11 U.S.C. § 364 (1988).

[17] After filing for bankruptcy, the debtor may be permitted to continue running the business as a debtor in possession (DIP). *See id.* § 1107 (generally giving a DIP all the rights and powers of a trustee). In some cases a "trustee in bankruptcy" (TIB) may be appointed to run the business. *See id.* § 926(a) (stating that where a debtor fails in his duties and obligations under the Code with respect to preferences, fraudulent transfers and conveyances, and other areas, "on request of a creditor, the court may appoint a trustee to pursue such cause of action").

[18] The additional capital allows management to maintain the daily operations of the business as if it were not in bankruptcy.

[19] Most prepetition assets of the debtor are subject to security interests that were granted to obtain prepetition credit. Accordingly, unless some of those security interests are avoidable, the only property available for securing fresh loans is that acquired by the DIP postpetition. *See id.* § 547(b) (granting the trustee the power to avoid certain preferential transfers); *id.* § 548(a), (b) (granting the trustee the power to avoid certain fraudulent transfers); *id.* § 544(a) (granting the trustee the power to avoid certain security interests); *id.* § 545 (granting the trustee the power to avoid certain statutory liens).

[20] On average, DIP loans mature in two years with two to three basis points in fees (2-3% of the total outstanding commitment) and rates at Prime plus 1-1/2 or LIBOR plus 2-1/2 (roughly 1-1/2% above the interest rate charged to the banks' best customers). These rates are very similar to those charged by senior debt in LBO financings in the 1980s, but the loan is substantially shorter than the five to seven year maturities of LBO senior debt. Telephone Interview with Kenneth A. Lang, Vice President, Structured

Consequently, many money-center banks that had excelled in leveraged buyout financing have shifted their emphasis to debtor-in-possession (DIP) financing.[21]

Although DIP financing plays a clear role in the Code as a postpetition vehicle, it is unclear what role it has prepetition. In practice, debtors may need to negotiate comprehensively for or agree to DIP financing prepetition.[22] Although, generally, prepetition executory contracts are assumable by the DIP to the extent that they bring value to the estate,[23] the Code does not allow such assumption of financial accommodation contracts.[24] Section 365(c)(2) of the Bankruptcy Code expressly prohibits the assumption or assignment of prepetition contracts made "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor . . . ."[25]

In a prepetition agreement for DIP lending, however, both the creditor and the debtor are clearly aware of the impending bankruptcy. Indeed, the bankruptcy filing is a necessary precondition to the execution of the DIP financing agreement. It is illogical, therefore, to require renegotiation of the financing agreement after the filing. Moreover, this renegotiation requirement undermines

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Finance, BT Securities Corp. (Feb. 5, 1992) [hereinafter Lang Interview].

[21] *See* Padley, *supra* note 15, at 1.

[22] Some debtors may want to compare the opportunities offered by bankruptcy with those offered in an out-of-bankruptcy workout. Other debtors may want to approach creditors with a prepackaged plan and need some idea of what DIP financing will look like. Finally, some debtors may simply desire to put in place some of the important features of their bankruptcy plan so that, upon filing, substantial negotiation of the DIP loan will already have occurred. Lang Interview, *supra* note 20; *see, e.g.*, *Colt's Files for Chapter 11 Bankruptcy Protection: The 156-year-old Gun Manufacturer Is Beset by Weak Sales*, L.A. TIMES, Mar. 20, 1992, at D2 (stating that Colt's agreed to its DIP financing the night before it filed for bankruptcy); Charles Storch, *Farley Inc. Still in Long, Often Tense Talks to Restructure Debt*, CHI. TRIB., Sept. 2, 1991, at C4 (stating that Farley Inc. was in negotiation "with Bank of New York for debtor-in-possession financing" prior to filing under Chapter 11).

[23] *See* 11 U.S.C. § 365(a)(1988) ("The trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.").

[24] The point at which prepetition discussions become enforceable contracts is a matter of state law and will vary depending on which jurisdiction's laws govern a particular agreement.

[25] 11 U.S.C. § 365(c)(2)(1988). As will be explored later, the reasons for the drafting of this section were to prevent prepetition creditors from being forced to extend further credit after bankruptcy was filed. *See infra* notes 62-63 and accompanying text.

the effort to speed the bankruptcy process through prepetition planning. The novelty of these prepetition agreements, however, means that challenges to the provisions of § 365(c)(2) have only recently come before the courts. The struggle between a literal reading of the Code, which clearly prohibits assumption of these agreements, and a reinterpretation based on the realities of the marketplace is apparent. Courts faced with prepetition financial accommodation agreements made by the parties in anticipation of bankruptcy have drawn conflicting conclusions.[26]

In the most recent case on point, *In re TS Industries, Inc.*,[27] the court found that prepetition workout agreements extending financial accommodations postpetition to a bankrupt are "not the type of agreement[s] that [were] contemplated as being barred from assumption under § 365(c)(2)."[28] This decision came down just four days after the Ninth Circuit had determined that "[s]ection 365(c)(2) unambiguously prohibits the assumption of financial accommodation contracts, regardless of the consent of the non-debtor party."[29] Although the *TS Industries* holding may well be the desirable result in light of the current bankruptcy environment—a point that is argued in this Comment—the logic of the court is tenuous in the face of the plain language of the statute prohibiting the assumption of financial accommodation clauses.

This ambiguity provides impetus for amending or redrafting § 365(c)(2). Uncertainty as to whether or not the Code will be read literally creates risk-shifting problems for the creditor and debtor. Instead of one interpretation which clearly leaves the risk with one party, allowing that party to contract accordingly, the uncertainty of

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[26] *Compare In re* TS Indus., Inc., 117 B.R. 682, 687 (Bankr. D. Utah 1990) (concluding that a prepetition workout entered into by the parties in anticipation of bankruptcy, which expressly anticipates incorporation of the terms into the reorganization plan, is *not* the type of agreement that § 365 (c)(2) intends to bar from assumption) *and In re* Prime, Inc., 15 B.R. 216, 217-18 (Bankr. W.D. Mo. 1981) (holding that financial accommodation agreements are assumable as long as the creditor consents, and that the statute should be read in the context of the statutory powers given the trustee to operate the business) *with In re* Sun Runner Marine, Inc., 116 B.R. 712, 718 (Bankr. 9th Cir. 1990) (holding that § 365(c)(2) unambiguously prohibits the assumption of financial accommodation contracts) *and In re* New Town Mall, 17 B.R. 326, 328 (Bankr. D. S.D. 1982) (finding that the intent of Congress is in the plain language of the statute and that financial accommodation agreements are not enforceable postpetition by the DIP).

[27] 117 B.R. 682 (Bankr. D. Utah 1990).

[28] *Id.* at 687.

[29] *In re* Sun Runner Marine, Inc., 116 B.R. at 718.

how the Code will be read pressures both the parties into entering contracts in which each must assume that the risk burden will fall on her. The uncertainty thereby creates systemic loss, because both parties must expend resources to protect against a single risk.

The risk to the debtor is particularly grave[30] because of the irreversible change of circumstance that filing for bankruptcy brings to the debtor's business. A debtor relying on its ability to assume the prepetition contract for DIP financing—either because it assumes that the statute will be interpreted to allow assumption (*TS Industries*), or because it believes that even if the statute is read to disallow assumption (literal reading), the market will force the creditor to make good on its promise to finance[31]—may find itself filing for bankruptcy only to find that its creditor is unwilling to

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[30] Clearly there is also risk for the creditor, though it is not as obvious as the risk to the debtor. For example, if the creditor simply relies on the plain language of the Code, disallowing assumability, the creditor will be less concerned with its prepetition negotiations as it presumes its ability to renegotiate postpetition. The creditor has incentives to reduce its costs prepetition if possible since competition for DIP financing necessarily reduces the perceived value to the creditor of winning the financing agreement. To illustrate, if there are four creditors vying for the DIP agreement and the anticipated fee is $4 million, each creditor will only anticipate receiving a $1 million dollar fee. Depending on the internal demands for specific returns on the transaction, each bank will only want to spend some amount less than the $1 million expected return in performing its due diligence and negotiation work. Reliance on the strict language of the Code, therefore, should induce the creditors to undertake what may amount to less than the necessary investigation that is required to perform the loan. Meanwhile, if the Code is read to allow assumption, the creditor may be forced to comply with an agreement which it did not anticipate to be binding. Accordingly, as competition intensifies and creditors take more risks in making DIP financings, the safety net created by the language of the Code becomes even more meaningful to creditors as they weigh the value of their prepetition expenditures.

[31] In the current bankruptcy environment, money-center banks have overwhelming incentives to stand behind their prepetition agreements for DIP financing because: (1) heightened competition among lenders to attract those demanding DIP loans necessitates a projection to the market of trustworthiness that would be shattered by walking out on a deal; (2) the sunken costs of labor hours and the need to get fees creates great incentive to follow the deal to conclusion; and (3) the floating nature of financing terms (i.e., Prime plus 1-1/2%) means that fluctuations in interest rates will not generally make a deal turn sour. Lang Interview, *supra* note 20.

Ultimately, however, it must be noted that the only reason for the improbability of such creditors' actions are the market forces currently in place. These forces act in spite of the Code, and any change in the market forces, such as a change from a demand to a supply market for DIP lending, would substantially increase the probability of such a scenario.

extend financing, hiding behind the "nonassumability" language of the statute. While such a change of heart by a creditor may be unlikely in the current market,[32] as DIP financing becomes more prevalent and more competitive,[33] it is logical that money-center banks will take more risks to win financing agreements, particularly if DIP financing proves to be highly lucrative. This added risk-taking would presumably be in the form of pricing (either lower fees and rates or different structures of rates, such as fixed rates) and covenants (less restrictive or less inclusive), both of which are valuable to the debtor, and both of which expose the creditors to added lending risks.

Accordingly, as time goes by, competitive pressures should make lending for DIP financing more dangerous, increasing the probability of a creditor choosing to opt out of its prepetition agreement in the event of unfavorable market changes. Paradoxically, as time goes by, and the number of successful DIP financings increases, debtors are likely to grow more confident in their ability to rely on prepetition DIP financing agreements, regardless of the language or interpretation of the statute. The potential catastrophe is obvious: a large debtor will file for bankruptcy only to find that the financing it was relying on to assist in its emergence from bankruptcy is no longer available. Such a change in plans endangers the successful reemergence of the company from bankruptcy, consequently jeopardizing the well-being of that company's employees, suppliers and customers, and the communities it serves.[34] Clearly, the Code should be changed to reflect the reliance that debtors place on the assumability of prepetition agreements for DIP financing, and to reduce the costs associated with unclear risk allocation due to conflicting interpretations of the Code.

This Comment first explores the Bankruptcy Code provisions regulating DIP financing and compares the transactions contemplated by statute with the practical operation of the current DIP

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[32] *See supra* note 31.

[33] *See* William Goodwin, *Borrowers in Chapter 11 Look Enticing*, AM. BANKER, May 4, 1990, at 1 (stating that "experts say [DIP financing] could rise dramatically").

[34] Arguably, this risk is particularly great assuming that larger, higher-profile DIP financings should draw the toughest competition. This line of reasoning would imply that a refusal by a creditor to stand behind its prepetition agreement for DIP financing is more probable in the context of very large DIP financings than in smaller financings, thus increasing the value of the assets, the number of employees, and the effect on the market of such a recision.

financing market. Next, the Comment offers a generalized case study of a distressed company and its interaction with lawyers and lenders to demonstrate the forces that have brought DIP financing agreements into prepetition. The Comment then turns to § 365, which contains the general assumption and rejection rules of executory contracts in bankruptcy, and analyzes its function within the Bankruptcy Code. Through an analysis of case holdings, the Comment will elucidate the problems faced by modern bankruptcy courts in interpreting § 365(c)(2) in light of the current bankruptcy environment. Finally, the Comment offers a simple proposal for amending § 365(c)(2), arguing for the addition of consent language that would clearly indicate that DIP financing agreements made prepetition are assumable postpetition by the DIP.

I. Debtor-in-Possession Financing: Statutory Provisions and Common Practice

Section 364[35] of the Bankruptcy Code is the statutory provision governing DIP financing. The section is a graded approach for attracting new financing postpetition. At the first level, the DIP, without court approval, may obtain unsecured credit "in the ordinary course of business" by granting an administrative priority[36] to the lender.[37] Since this type of credit applies only to "ordinary course of business" transactions, it tends to be limited to trade credit, which is rarely substantial enough to help the DIP operate its business in bankruptcy. At the second level, the DIP can grant an administrative priority to obtain unsecured credit *not* in the ordinary course of business, but only with court approval.[38] The insubstantial protection of administrative priority, however, creates little incentive for creditors to lend to DIPs, and such priority will rarely attract sufficient funding to help the operation of the DIP's business.[39] More importantly, the section provides for the grant-

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[35] 11 U.S.C. § 364 (1988).

[36] A creditor with an administrative priority will be the first unsecured creditor to receive a distribution of assets of the estate. *See* 11 U.S.C. § 507(a)(1) (1988).

[37] *See id.* § 364(a) ("[T]he [DIP] may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable under section 503(b)(1) of this title as an administrative expense.").

[38] *Id.* § 364(b) ("[T]he court, after notice and a hearing, may authorize the trustee to obtain unsecured credit or to incur unsecured debt other than under subsection (a) . . . as an administrative expense.").

[39] Although an administrative priority gives a creditor priority over

ing of various levels of superpriority to prospective lenders that would subordinate other *secured* creditors to the new DIP financier.[40] These superpriority loans may have become more the norm than the exception,[41] and although the debtor's original creditors would seem to suffer by losing their priority, the larger senior debt creditors rarely object.[42]

The statute requires court authorization for this type of superpriority postpetition financing.[43] Read alone, this requirement seems to imply that negotiation with lenders should not begin until *after* a bankruptcy petition has been filed.[44] In order to receive such financing, however, the DIP must move for a financing order.[45] Such a motion application requires that the proposed DIP financing agreement be attached.[46] Given the time necessary to negotiate fully a DIP financing, and the pressing financial needs of the DIP, Rule 4001(c)(1) would seem effectively to require the debtor to initiate DIP financing negotiations prepetition.[47] In practice, the debtor will approach its lenders, solicit loan commitment letters, and will likely agree to the DIP facility with the most

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other unsecured creditors, if there is no distribution to unsecureds, such priority may be useless. *See* Joseph H. Levie, *Financing the Debtor-in-Possession: Superpriorities and Financing Orders*, N.Y. L.J., July 11, 1991, at 5 (stating that "[t]here are few instances in which a lender has been willing to finance a debtor-in-possession solely on the basis of an administrative priority").

[40] *See* 11 U.S.C. § 364(d)(1)(1988) ("The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate . . . ."); *see also id.* § 364(c) (authorizing the granting of priority over other administrative expenses, the granting of a lien on otherwise unencumbered property, or the granting of a junior lien on property already subject to a lien).

[41] *See* Goodwin, *supra* note 33, at 1.

[42] *See* Thomas G. Donlan, *Super-security or Super-scam? Financing for Bankrupt Companies Goes Too Far*, BARRON'S, Feb. 3, 1992, at 10 (stating that "[o]riginal creditors usually don't fight DIP lending. Even though they may realize they are being shafted, they are resigned to being shafted somehow in a Chapter 11 reorganization"). *But see* Levie, *supra* note 39, at 6 (predicting that "[i]f pre-existing secured lenders are to be primed . . . without their consent, an extended and contentious hearing may be expected").

[43] *See* 11 U.S.C. § 364(c), (d)(1988).

[44] As discussed later, read with 11 U.S.C. § 365(c)(2), this would certainly seem to be the result intended. *See infra* notes 67-71 and accompanying text.

[45] *See* FED. R. BANKR. P. 4001(c)(1) (1988).

[46] *See id.* ("The motion shall be accompanied by a copy of the [financing] agreement.").

[47] *See* Levie, *supra* note 39, at 6. Indeed, there may be a need to move beyond negotiations to a formal agreement. A full agreement is not necessarily rare. Lang Interview, *supra* note 20.

attractive structure.[48] Although, intuitively, it may not be clear why companies would feel the need to agree to prepetition DIP financing arrangements, an examination of the market forces at work brings to light the pressures that drive these agreements.

Experiences with failing companies allow for some generalizations regarding the plight of the distressed prepetition debtor.[49] As cash flow falls short of the requirements of various debt agreements, the distressed company will often either try to extend the terms of, or default on, its trade credit and other debt.[50] At this point, the company is often approaching insolvency, meaning that liabilities will soon exceed assets, leaving little or no value for the equity holders. For managers and directors, who are typically equity holders (especially in mature leveraged buyouts where a limited number of equity holders took the company private),[51] there is a strong incentive to find ways to maximize investment by weighing available means to enhance share value.[52] In order to evaluate the various options available, however, all aspects of out-of-bankruptcy workout and in-bankruptcy reorganization must be considered, as the risk of not doing so can be substantial, depending on the managers' investment.

To explore its options, the distressed company will typically engage lawyers and investment bankers. One team of advisors will

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[48] Lang Interview, *supra* note 20.

[49] Almost all of the information noted here was derived from a telephone conversation with Mark C. Wheeler, Jr., Executive Vice President of Fleet Bank of Massachusetts, on Feb. 10, 1992, who dealt with various prominent distressed companies while working for a major money-center bank in New York [hereinafter Wheeler Interview].

Whereas a specific example might have been more interesting, the need for confidentiality regarding various situations prevents anything more than a generalized account.

[50] For example, Macy's initial default on its trade debt left secured creditors wondering whether they would be next. *See* Laura Zinn, *A 'Death Knell' at Macy's?*, BUS. WK., Jan. 27, 1992, at 28; *see also* Paul Sweeting, *Orion Pictures Files for Chapter 11 Protection*, BILLBOARD, Dec. 21, 1991, at 10 (discussing Orion Pictures' default on interest and principal payments under its bank-credit agreements).

[51] *See generally* William Taylor, *Crime? Greed? Big Ideas? What Were the '80s about?*, HARV. BUS. REV., Jan.-Feb. 1992, at 32 (generally discussing the major equity investors of the eighties).

[52] *See, e.g.*, Zinn, *supra* note 50, at 28 (indicating that Edward Finkelstein, the C.E.O. of Macy's, invested $4.4 million in the initial LBO, while Laurence Tisch invested nearly $15 million). These sums of money are indeed a strong incentive when they are completely at risk if the company files for Chapter 11 protection.

examine the possibilities of out-of-bankruptcy rehabilitation and workout through negotiations with existing creditors. Another team will explore bankruptcy reorganization through negotiations for DIP financing, attempt to obtain commitment letters from prospective DIP lenders, and analyze the relative value of bankruptcy reorganization to the company.[53]

The engagement of advisors creates several added pressures on the company. First, pressure will come from the advisors if they perceive that bankruptcy is imminent; the desires of these advisors to secure their fees prior to the bankruptcy filing can increase pressure on the company successfully to negotiate and contract for DIP financing prepetition.[54] Thus, there is a tendency towards having DIP financing contracts fully negotiated and agreed to, subject to substantial caveats, prior to filing.[55] Second, pressure may come from creditors that are not included in the negotiations. These creditors, fearing that they are being "cut out of the deal," may opt to force an involuntary bankruptcy on the company.[56] The threat of premature bankruptcy influences the company to negotiate prepetition agreements more thoroughly and more quickly, so that a financing plan is already in place in the event of an involuntary filing. Third, pressure may come from the creditors with whom negotiations are being held. If most of the debt is held by a few large creditors, they may pressure the debtor into adopting a prepackaged plan favorable to their interests,[57] concurrently pressuring the debtor to contract for DIP financing that is acceptable to the creditors.

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[53] Telephone interview with Arthur M. Goldberg, Chairman of the Board and Chief Executive Officer, Bally Manufacturing Corp. (Feb. 12, 1992) [hereinafter Goldberg Interview].

[54] *See In re* Drexel Burnham Lambert Group, Inc., 133 B.R. 13 (Bankr. S.D.N.Y. 1991) (describing the "lodestar" approach to attorney's fees in Chapter 11 and questioning the reasonableness of financial advisory fees in Chapter 11). Clearly, there is uncertainty as to what compensation will be allowed by the bankruptcy court, and prepetition fees will be substantially more attractive as they are not governed by the perceptions of the court. For the DIP lender, however, who knows that postpetition fees are guaranteed by winning the prepetition beauty contest, getting a completed contract for DIP financing provides added assurance that fees will be forthcoming.

[55] Lang Interview, *supra* note 20.

[56] Goldberg Interview, *supra* note 53; *see also* 11 U.S.C. § 302 (1988) (explaining the requirements of involuntary bankruptcy filing).

[57] *See, e.g.*, Zinn *supra* note 50, at 29 (stating that Macy's large lenders "would be happier with a prepackaged bankruptcy filing—a quickie that favors large debt-holders by bringing them into the restructuring process").

The most important reason for the DIP's urgency in successfully negotiating a financing agreement prepetition is that management knows that the company will face significant capital needs as soon as bankruptcy is filed. Indeed, depending on the nature of the company's business, financing may be needed on the day of filing.[58] In order to have a DIP financing agreement in place at the time of filing, the company must fully negotiate, if not agree to, a DIP financing plan prepetition. Moreover, since the current market forces leave little risk with the debtor in relying on these agreements, there seems to be little reason not to contract for DIP financing prepetition.[59] Despite the above pressures and incentives for companies to enter into contracts for DIP financing prepetition, the Bankruptcy Code fails to recognize explicitly the practical needs of debtors contemplating Chapter 11 protection. The application of § 365, therefore, must be reexamined.

II. SECTION 365

Section 365 of the Bankruptcy Code deals with the assumption or rejection by the DIP in bankruptcy of executory contracts. The executory contract in bankruptcy is typically defined as "a contract in which substantial performance obligations remain on both sides of the agreement at the time that one party to the agreement files bankruptcy."[60] Because a prepetition agreement for DIP financing would seem to satisfy this definition–substantial performance is required by the debtor who must file for bankruptcy, and substantial performance is required by the creditor who must lend after bankruptcy is filed–the requirements of § 365 come to bear on otherwise binding prepetition DIP financing agreements. Section 365 generally gives the DIP the discretion, under the auspices of the bankruptcy court, to assume an executory contract if the DIP

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[58] This is particularly true for a retailer because the working capital needs are high when the business relies on substantial inventory. Wheeler Interview, *supra* note 49.

[59] *See supra* note 31.

[60] Raymond T. Nimmer, *Executory Contracts in Bankruptcy: Protecting the Fundamental Terms of the Bargain*, 54 U. COLO. L. REV. 507, 508 (1983); *see also* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973) (defining an executory contract as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other").

believes its performance would create a net gain to the estate. This situation differs significantly from the scenario where only one of the contractual parties has substantially performed its obligations. If the nonbankrupt party is the substantial performer, it has a claim against the estate, whereas if the bankrupt party is the substantial performer the DIP can demand performance of the contract.[61]

Significantly, the DIP's assumption of an executory contract means that the obligation of the nonperforming party comes due not in the normal course of business but in postpetition bankruptcy. Prior to 1978, such a change of circumstance could be especially damaging to lenders. Many loans, particularly revolving credits, credit lines, letters of credit, and unexpired leases, could be construed as executory contracts since such agreements contemplate further lending by the creditor and borrowing by the debtor. Accordingly, under the predecessor to the modern § 356 these agreements could be assumed by the DIP (with approval by the bankruptcy court), effectively forcing lending institutions to extend further financing to a bankrupt. The absurdity of this result was persuasively argued at the hearings concerning the 1978 redrafting of the Code[62] and § 365 was amended to provide an exception for lenders to the general rule of assumability.[63]

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[61] *See* Countryman, *supra* note 60, at 451-60. For an example of a half-performed contract, see Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989):

> [S]uppose the debtor-seller had delivered . . . onions before bankruptcy, leaving nothing but the estate's inherited right to payment of $500 by the Other Party. Unless the cost of suit exceeded $500, the trustee would simply enforce the right and get the money. By the same token, if the Other Party buyer had paid the $500 before bankruptcy but the onions had not been delivered . . . the trustee would have the simple choice of performing the obligation, picking and delivering the onions, or paying damages for nonperformance. . . *Id.* at 251 (footnote omitted).

Note that the claim of the Other Party will be treated as an unsecured claim, and will be paid out of the distribution of the estate to the unsecured creditors. *See id.* at 292.

[62] *Hearings of the Senate Committee on the Judiciary*, 95th Cong., 1st Sess. 576 (1977) (statement of Robert Grimmig, representative of the American Bankers' Association) ("[W]e believe that this problem must be met by a clear amendment of § 365 to preclude the preposterous situation of a lending institution being required to make a loan to a bankrupt.").

One might also argue here that it is equally absurd to require a seller to go forward on delivery of goods to a bankrupt (which is the result of standard assumption of an executory contract under § 365(a)) because it is like forcing the contracting party to extend credit as well.

[63] *See* 11 U.S.C. § 365(c) (1988); *see also id.* § 365(a) ("Except as provided in

The amended section, § 365(c)(2),[64] clearly defines the exclusions which Congress chose to make:

> The trustee may not assume or assign any executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if . . . such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor. . . .[65]

Thus, the current version of § 365 allows the DIP to assume in postpetition all executory contracts unless they are specifically excluded in the defined subsections of § 365. The risk of further obligation after bankruptcy for these nonexcluded contracts is borne by the non-bankrupt party to the contract. Contracts that are specifically excluded from § 365 leave risk with the debtor because in order for the DIP to realize a benefit from these contracts they must be renegotiated post-bankruptcy. The plain language of the § 365(c)(2) exclusion therefore seems to indicate an intent to allow postpetition renegotiation of executory contracts for financial accommodations, thereby shifting risk away from prospective lenders.

A. *The Interaction of § 365(c)(2) with § 364*

As previously mentioned, prepetition agreements for DIP financing are best categorized as executory contracts falling under the regulation of § 365 in that they satisfy the "substantial performance obligations remain[ing] on both sides" definition of Countryman and Nimmer.[66] Courts have also agreed on this point.[67] Accordingly, the "nonassumability" exception of § 365(c)(2) bears

sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor.").

[64] *See* S. REP. NO. 989, 95th Cong., 2d Sess. 58-59, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5844-45; H.R. REP. NO. 595, 95th Cong., 1st Sess. 348, *reprinted in* 1978 U.S.C.C.A.N. 5963, 6304.

[65] 11 U.S.C. § 365(c)(1988).

[66] *See supra* note 60 and accompanying text.

[67] *See, e.g., In re* TS Indus., Inc., 117 B.R. 682, 685 (Bankr. D. Utah 1990) (interpreting §365 to apply to executory contracts that the debtor enters prepetition); *In re* Prime, Inc., 15 B.R. 216, 218 (Bankr. W.D. Mo. 1981) (holding that the debt financing arrangement was an executory contract governed by § 365); *In re* Sun Runner Marine, Inc., 116 B.R. 712, 717 (Bankr. 9th Cir. 1990) (noting that generally § 365 governs the postpetition continuation of prepetition contractual relations).

directly on the prepetition DIP financial agreements in question in that they "make a loan, or extend other debt financing" to the bankrupt.[68] Application of § 365 to these agreements, however, essentially guts their usefulness to the DIP. The prepetition negotiations with the lender notwithstanding, these contracts cannot be assumed postpetition following the clear language of § 365(c)(2). The overlap of § 364 and § 365 demonstrates either that Code drafters intended to prohibit prepetition agreements for DIP financing (a point which is difficult to reconcile with the apparent reasons for adding § 365(c)(2) described above) or simply that Code drafters did not anticipate that prepetition agreements for DIP financing would occur. Regardless, the statutory framework would seem to make these prepetition agreements binding only to the extent that the lender is willing to reaffirm its obligation under the contract after bankruptcy has been filed.

Thus, whereas § 364 is mute in proscribing when DIP agreements should be made, because Rule 4001(c)(1)[69] requires a financing agreement to be reached before the court will grant a financing order,[70] and more importantly, because of the pressures of market forces,[71] debtors are compelled to agree to these financings prepetition. Section 365(c)(2), however, as literally written, states that these contracts are not assumable by the debtor postpetition.

This interpretation of the two sections is difficult to reconcile with reality, considering that both the DIP financing lender and the debtor understand that the loan will only occur if there is a subsequent bankruptcy filing. Although it is appealing to assume that the drafters simply could not have intended such a preposterous reading of the statute, the literal reading of § 365(c)(2) is hard to ignore.

B. *Judicial Attempts to Redefine the Role of § 365(c)(2)*

Finding § 365(c)(2) inapplicable to prepetition negotiations for DIP financing would be one way of resolving these apparent contradictions in the Code, and in fact, some courts have valiantly tried to reinterpret this section of the Code in order to enforce prepetition lending agreements. However, reliance on the courts is

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[68] 11 U.S.C. § 365(c).
[69] FED. R. BANKR. P. 4001(c)(1) (1991).
[70] *See supra* notes 45-47 and accompanying text.
[71] *See supra* note 31.

a less than optimal means of responding to the problem, as there is little evidence that Congress intended anything beyond the plain language of the statute.[72] Indeed, the court decisions that have made the reinterpretation arguments demonstrate a particular frailty that any argument without a clear amendment to the Code faces.

In re TS Industries, Inc.[73] is the most recent attempt at reinterpretation and clearly demonstrates the shortcomings of arguments made in favor of reinterpreting the Code to allow for enforcement of prepetition lending agreements. Moreover, *TS Industries* exemplifies the unexpected extremes to which some courts may be willing to go to force a rereading of § 365. Instead of presenting a situation in which the debtor is trying to assume a prepetition agreement for DIP financing, *TS Industries* involves a debtor trying to reject the agreement. Most simply, the court could have chosen to read the statute literally, finding that the debtor could not assume such a contract—the equivalent of allowing the debtor to reject the agreement. Instead, as will be discussed, the court went to great lengths to redefine § 365(c)(2) in order to allow a debtor the option of assuming these contracts.

TS Industries involved a prepetition agreement among TS Industries on the one hand, and its wholly-owned subsidiary Won-Door, certain TS Industries shareholders, and several of its creditors, on the other. The purpose of the agreement was "to reinstate TS' obligations to its debentureholders, restructure a TS-Credit Suisse line of credit, and provide for repayment of that line of credit through certain stock transactions . . . and financing by Won-Door."[74] The agreement explicitly contemplated that these steps would be taken in conjunction with TS' filing for bankruptcy.[75] After filing, however, TS determined that the deal was no longer feasible (as did the other parties to the agreement) and presented a reorganization plan which contemplated that assumption of the original agreement would be prohibited by § 365(c)(2). Other creditors, favoring the original prepetition agreement, argued that § 365(c)(2) did not apply to this kind of transaction and attempted to have the new reorganization plan rejected.[76] Inter-

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[72] *See infra* notes 86-91 and accompanying text.
[73] 117 B.R. 682 (Bankr. D. Utah 1990).
[74] *Id.* at 684.
[75] *See id.*
[76] *See id.* at 684-85.

estingly, all of the parties to the prepetition agreement argued for a literal reading of § 365(c)(2), while third-party creditors argued for the more narrow interpretation.[77] The court, agreeing with the third-party creditors, redefined the scope of § 365(c)(2) to exclude prepetition agreements in which both the debtor and creditor expressly contemplated bankruptcy when entering into the agreement.[78]

The first argument of the court is that Congress could not have intended to shield *consenting* creditors from the assumption of prepetition agreements for postpetition financial accommodations. To make the argument, the court compares §§ 365(c)(2) and 365(e)(2)(B)[79] and infers that because the latter section excepts financial accommodation contracts from the general rule that voids clauses restricting the debtor's right to assume or assign a contract postpetition because of insolvency or financial condition,[80] it is inferable that Congress intended to protect financing creditors from *involuntary* extensions of credit when bankruptcy created a "fundamental change in circumstances [that] warrant[ed] the parties reassessing their deal through the tool of non-assumption under § 365(c)(2)."[81]

The gravamen of this argument is that the purpose of the § 365(c)(2) exception is to avoid prepetition executory contracts for financial accommodations in the event of a significant or fundamental change in circumstance. This is essentially an argument borrowed from contract law principles of commercial impracticability or frustration.[82] Knowledge of the impending bankruptcy by

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[77] This position is particularly interesting in light of the earlier discussion of the operation of § 365. *See supra* notes 66-71 and accompanying text. Even if the § 365(c)(2) hurdle is overcome, the DIP still has the option, under the supervision of the court, of rejecting the contract. If TS Industries had already indicated its desire not to enforce the contract, the third-party creditors would have to demonstrate that rejection of the plan was an abuse of the DIP's business judgment and offer a competing plan that incorporated the original agreement. The court would then have to decide which plan to approve. *See TS Industries*, 117 B.R. at 689; *see also* FED. R. BANKR. P. 6006 (1988) ("When a motion is made [to assume, reject, or assign an executory contract] the court shall set a hearing on notice to the other party to the contract . . . .").

[78] *See TS Industries*, 117 B.R. at 687.

[79] 11 U.S.C. § 365(e)(2)(B)(1988).

[80] *See* 11 U.S.C. § 365(e)(1)(A)(1988). These clauses are commonly referred to as *ipso facto* clauses.

[81] *TS Industries*, 117 B.R. at 687.

[82] For an instructive discussion of commercial impracticability and frustration, see, e.g., American Trading and Prod. Corp. v. Shell Int'l Marine

the parties would therefore negate the justification and presumably bring the agreement outside of § 365(c)(2). That is, if the risk that would frustrate the purpose of the contract is fully acknowledged by the parties during negotiation, then it is hard to argue that such a risk could frustrate the contract.

However, by essentially making a contract law argument, the court confuses the respective roles of contract law and bankruptcy law. If state contract law would void the contract in the event of bankruptcy,[83] a court could reason that the contract was not assumable because it was void under state law at the time of filing and, therefore, not property of the estate. Once the contract is deemed to exist, however, (and the court must find that it does to reach the § 365 issue) then bankruptcy law takes over, and it is anomalous to apply state contract law principles in determining the meaning or intent of the Bankruptcy Code.[84]

This distinction is important because, as discussed earlier, the history of § 365 indicates that it is meant to provide an opportunity for the assumption of value by the DIP.[85] This opportunity comes only at the risk of the other party to the contract, and § 365(c)(2) seems to have been written to shield certain other parties, namely creditors, from that risk. Therefore, the question is whether the drafters of § 365(c)(2) intended to shield creditors from such risk only to the extent that the creditors did not consent to the filing of bankruptcy (the *TS Industries* position), or whether they intended to shield the creditor absolutely, knowing that the prepetition agreement could always be renegotiated postpetition. This issue is highlighted in *In re Sun Runner Marine, Inc.*,[86] in which the court theorized that if the intent of Congress was only to protect those

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Ltd., 453 F.2d 939, 941-44 (2d Cir. 1972) (dismissing a claim for additional costs because war had broken out in the Suez Canal region and substantial costs were incurred to make contracted shipment).

[83] It is assumed here that the court is arguing that the contract was void because the onset of bankruptcy made it commercially impracticable. Therefore, no contract existed to become property of the bankruptcy estate. Certainly this is a somewhat strange argument, but it is tantamount to what the *TS Industries* court attempts to rationalize.

[84] *See also* Westbrook, *supra* note 61, at 285-87 & n.248 (explaining some of the problems that may arise from bankruptcy law conflicting with state contract law). Presumably, if every court applied state law contract principals to interpret the meaning of the Bankruptcy Code, a wide variety of interpretations would exist.

[85] *See supra* notes 60-61 and accompanying text.

[86] 116 B.R. 712 (Bankr. 9th Cir. 1990), *aff'd in relevant part*, 945 F.2d 1089 (9th Cir. 1991).

creditors that did *not* contemplate bankruptcy as an integral part of the financial agreement, Congress could have added a clause, as it has in other sections of the Code, excluding from the scope of § 365(c)(2) those lenders who consent to assumption in the prepetition agreement.

> By way of comparison, § 365(c)(1) prohibits the assumption of certain contracts . . . *only* when the non-debtor party to the contract does not consent to assumption. Subsection 365(c)(2) is the very next subsection, and it prohibits the assumption of all financial accommodation contracts with no reference to the consent of the non-debtor party to the contract.[87]

Considering the juxtaposition of §§ 365(c)(1) and 365(c)(2), the lack of clarification in the latter section is unlikely to have been a "mere oversight of the drafters."[88] Moreover, this strict reading of the statute is not confined to the *Sun Runner* case. Several earlier cases, including *In re Swift Aire Lines, Inc.*[89] and *In re New Town Mall*,[90] also found that the clear intent of Congress was that "a debtor-in-possession cannot assign or assume an executory contract for financing."[91]

Thus, arguments that certain risk shifting was not *intended* by the drafters is suspect, particularly when the argument is based on principles derived from contract law. Laudable as the result of shifting risk back to the creditor in this context may be, if it is reached through the application of contract rather than bankruptcy principles, it is of questionable validity.

The court's second argument in *TS Industries* attacks the folly of withholding permission to assume a prepetition agreement when the creditor has clearly consented to the assumption, particularly in light of the Chapter 11 goal of allowing the trustee to operate the business after bankruptcy.[92] Other courts have also held that consent is an important factor in determining the existence of a § 365(c)(2) exception,[93] and this Comment urges such a conclusion

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[87] *Id.* at 717.

[88] *Id.*

[89] 30 B.R. 490, 496 (Bankr. 9th Cir. 1983).

[90] 17 B.R. 326, 327 (Bankr. D.S.D. 1982).

[91] *Id.*

[92] *See In re* TS Indus., Inc., 117 B.R. 682, 687 (Bankr. D. Utah 1990).

[93] *See generally In re* Charrington Worldwide Enters., Inc., 98 B.R. 65, 68 (Bankr. M.D. Fla. 1989), *aff'd* 110 B.R. 973 (Bankr. M.D. Fla. 1990) (stating that "[t]he legislative history of [§ 365(c)(2)] leaves no doubt that this exception to the assumability of executory contracts was drafted for the purpose of assuring that contracts to lend money or to extend credit . . . should not

as well: it is more realistic to allow prepetition negotiation for financial accommodation executory contracts or DIP financings, and more in line with the Code's preference towards efficient and speedy bankruptcies. This argument, however, is problematic given the current language of the Code.

While the current Code does seem to emphasize the importance of certain prepetition activity in creating greater efficiency in the postpetition bankruptcy proceedings,[94] many of these provisions require consideration of all the creditors and not merely individual credit agreements.[95] Therefore, the court's conclusion that there is an emphasis on permitting the trustee to run the business after bankruptcy, and hence, an emphasis on permitting prepetition agreements that are intended to operate after bankruptcy[96] is only half right—the emphasis is conditioned on the perceived fairness of the prepetition agreement to all creditors.[97] Indeed, if Congress' desire to permit the trustee to run the business postpetition was so overwhelming, one must question why there is a § 365(c)(2) exception at all that hinders the DIP's ability to assume an executory contract. The question is one of degree, and simply stating that a particular result is foolish is insufficient to create a basis for clear and consistent future reinterpretation.

The court's final point is that the legislative history of the Code in conjunction with its provisions for prepackaged plans evidences a preference for workouts and private negotiations.[98] The court posits that the reinterpreted reading of § 365(c)(2), allowing assumption of prepetition agreements for financial accommoda-

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be assumable without the consent of the other party to the contract"); *In re* Adana Mortgage Bankers, Inc., 12 B.R. 977, 987 (Bankr. N.D. Ga. 1980) (indicating that consent might be a condition by which an executory contract to extend financial accommodations would fall outside the realm of the § 365(c)(2) exception).

[94] *See generally* 11 U.S.C. §§ 1102(b)(1), 1121(a), 1126(b) (all contemplating prepetition activity to facilitate post-filing expediency); *see also supra* notes 45-47 and accompanying text (discussing the requirements of Bankruptcy Rule 4001(c)(1) that necessitate prepetition negotiation with DIP financers).

[95] This point is perhaps most obvious in the § 1102(b)(1) provision which requires that prepetition creditors committees be "fairly chosen and ... representative of the different kinds of claims to be represented."

[96] *See TS Industries*, 117 B.R. at 687-88.

[97] *See also Sun Runner Marine*, 116 B.R. at 718 ("[Section] 365 is designed to protect not only the interests of the parties to the executory contract in question, but also the interests of all of the creditors.") (citing *In re* Placid Oil Co., 72 B.R. 135 (Bankr. N.D. Tex. 1987)).

[98] *See TS Industries*, 117 B.R. at 688.

tions, would necessarily encourage these desired workouts.[99] Although there is academic and legislative support for the court's premise that bankruptcy is intended as a last resort when prepetition mutual agreement fails,[100] it is not clear that the court's reinterpretation of § 365(c)(2) would stimulate such workouts any more than the literal reading of the section.

To understand this point, it is important to realize that in discussing workouts, the *TS Industries* court unwittingly lumps together several types of creditors—some of whom might be more willing to lend money if § 365(c)(2) were interpreted so as to stimulate workouts more than a literal reading of the section. One such distinct group of creditors is those who only want to lend money in a prepetition workout. For these creditors, the operation of § 365(c)(2), read literally, makes lending safer in that the creditors do not bear any risk that they will have to lend money to a bankrupt. Consequently, and in contradiction of the court's inference that a reinterpretation of § 365(c)(2) will encourage more workouts, these creditors will feel secure in making more loans available to debtors.[101] A second group of creditors includes those who contemplate lending money both prepetition and postpetition.[102] For these creditors, the literal operation of § 365(c)-(2) would also seem to make both the prepetition and postpetition financing less risky for the reasons just stated, and because these creditors know that they will have the chance to renegotiate the postpetition financing after filing. Again, contrary to the court's

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[99] *See id.* at 688-89.

[100] *See e.g.,* H.R. REP. NO. 595, 95th Cong., 1st Sess. 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179-80 (explaining that most reorganizations occur out of court and stating that "[w]hen an out-of-court arrangement is inadequate to rehabilitate a business, the bankruptcy laws provide an alternative"); S. REP. NO. 989, 95th Cong., 2d Sess. 10 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5796 (describing reorganization under Chapter 11 as "literally the last clear chance" for investor protection); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain,* 91 YALE L.J. 857, 867 (1982) (commenting that "[o]ne would normally expect to see consensual deals among creditors outside of the bankruptcy process attempted first . . . .").

[101] Of course these lenders could also use *ipso facto* clauses under § 365(e) to protect themselves, see *supra* notes 79-81 and accompanying text, but there is a cost to the creditor of added protection—contracts without *ipso facto* language are more desirable to debtors than are contracts with the language, and fees and rates should reflect that cost.

[102] *See, e.g., Sun Runner Marine,* 116 B.R. at 714-15 (debtor entered bankruptcy with an unexpired contract governing financial arrangements that was assumed postpetition as an executory contract).

inference, the literal reading of § 365(c)(2), and not the reinterpretation, would seem to stimulate workouts.[103]

A final group of creditors comprises those DIP lenders who negotiate and contract prepetition. Certainly for these lenders, the literal reading of § 365(c)(2) would seem absurd in that an informed prepetition agreement to finance the debtor after bankruptcy cannot be assumed,[104] but as discussed earlier, it is not clear whether the Code actually intends that contracts for DIP financing be negotiated and finalized prepetition. Section 364 implies that negotiation should occur only after court approval, whereas Rule 4001(c)(1) implies that negotiation is necessary prepetition, and § 365(c)(2), read literally, denies assumption of such contracts. Thus, in the case of DIP financing, the court's third argument may also be invalid—a reading of the Code would imply that § 364 DIP financing contracts should not occur prepetition regardless of other provisions favoring prepetition planning.

In sum, the plain language of the Code directly conflicts with the analysis presented in *TS Industries*, making it difficult to accept the conclusions of the court. Nevertheless, the *TS Industries* court's attempted reinterpretation of § 365(c)(2) should be viewed as an admirable reaction in an environment in which a literal reading of the Code makes no sense from either the perspective of bankruptcy law or contract law. A rewriting or amendment of § 365(c)(2), and not judicial reinterpretation, is the only way explicitly to define the risks and permit the growth of DIP financing when appropriate.

III. AN ARGUMENT FOR THE REWRITING OF § 365(C)(2)

Bankruptcy law encompasses several, often competing objectives that interface with external law. Within chapter 11 of the Bankruptcy Code, these competing interests tend to revolve around the desire to rehabilitate the debtor because, in an economic sense, the tangible and intangible benefits of an "ongoing operation" tend to create value.[105] There is value both to the creditors from the continued operation of the business rather than from its liquidation, as well as external value to the community which benefits from the

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[103] Supporting the *TS Industries* court's inference is the notion that allowing such agreements to be assumable would provide added leverage to debtors in prepetition against other third-party creditors.

[104] *See supra* text at 25-26.

[105] A desire to preserve the going concern value of business enterprises infuses much of the analysis in H.R. Rep. No. 595. *See supra* note 64.

business' products. The other, sometimes competing, policy is to maximize recovery to the original creditors by fairly distributing assets under a structure that treats similarly situated creditors equally.[106]

It is in the pre-bankruptcy context that these internal policies of bankruptcy law most obviously interact with external law, and, most important to this Comment, to contract law in particular. As stated by Raymond Nimmer:

> The objective [in pre-bankruptcy] is to structure bankruptcy rules so as to facilitate financial transactions by a debtor struggling to survive without filing bankruptcy. Typically, the rules protect a third party who has dealt with such a debtor, thereby reducing the perceived risk to that party and increasing the probability that the transaction will occur under relatively normal terms.[107]

For prepetition lenders for whom lending is not contingent on the filing of bankruptcy, § 365(c)(2)'s protection from the risk of bankruptcy filing would seem to serve these perceived policy goals of the Bankruptcy Code.[108] The benefit of this section is not apparent, however, in the context of prepetition agreements for § 364 DIP financing in which lenders have contemplated bankruptcy. There are really two reasons for this problematic interaction of § 365(c)(2) and DIP financing under § 364. The first is based on Nimmer's argument[109] that the Code should facilitate rehabilitation of the debtor without filing for bankruptcy. By disallowing prepetition agreements for postpetition DIP financing,[110] the Code fails to recognize the creation of two important sources of value for the debtor: first, the debtor's ability to secure DIP financing in prepetition enables her to weigh carefully the relative merits of out-of-bankruptcy workout with bankruptcy reorganiza-

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[106] *See Report of the Commission on the Bankruptcy Laws of the United States*, H.R. DOC. NO. 137, part 1, 93rd Cong., 1st Sess. 70-71 (1973) (discussing the various goals of the bankruptcy system).

[107] Nimmer, *supra* note 60, at 510.

[108] Because these creditors are shielded from bankruptcy, they are free to contract with the debtor with much less risk to the contract (that is, no risk of having further to extend financing after bankruptcy has been filed). This limitation on the lender's risk allows more normal contracting and arguably a better chance for debtors to secure financing that could lead to recovery outside the context of bankruptcy.

[109] *See supra* text accompanying note 107.

[110] Arguably, because prepetition agreements are unenforceable postpetition, they are effectively disallowed, at least to the extent that the debtor cannot clearly rely on such agreements.

tion, and second, DIP financing agreements can create an added weapon in prepetition to encourage lenders to settle outside of bankruptcy.[111]

The financial needs of the debtor are also poorly served by the present statutory framework. As previously discussed, depending on the working capital requirements of the debtor, DIP financing may be needed on or about the day that filing occurs.[112] Such financing can be assured only if the debtor has had a chance fully to negotiate DIP financing prepetition under a framework in which it can rely on those agreements. Section 365(c)(2), however, does not statutorily recognize this need of the debtor. Consequently, the risk that the debtor will have to file for bankruptcy is increased because the debtor will be unable to purchase inventory and run the business until more protracted postpetition negotiations for DIP financing are successfully completed.

Regardless of the force of these arguments, debtors and lenders, pressured by market forces,[113] have essentially disregarded § 365-(c)(2) and acted as if prepetition agreements are enforceable after bankruptcy.[114] In order for the Code to conform to common practice and to recognize that DIP financing should be assumable under its provisions, only a very simple amendment to § 365(c)(2) is necessary.

The most straightforward method of amendment might simply be to qualify § 365(c)(2) by adding an exception for contracts in which the creditor consents prepetition to assumability by the DIP

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[111] Not everyone will agree that giving the debtor extra leverage vis-a-vis its creditors is a good idea. *See, e.g.*, *Donlan*, *supra* note 42, at 10 ("Talk of broken legs or debtors' prison makes you nervous? Under today's Bankruptcy Code, debtor-in-possession financing, or DIP lending, is just as extreme, in the opposite direction."). However, if one purpose of the Code is to stimulate settlements outside of bankruptcy, and at the same time, the Code clearly contemplates DIP financing, it seems hard to argue that the debtor should not be able to negotiate DIP financing terms prepetition so that it can demonstrate to creditors the very real possibility of a new superpriority financing in postpetition. The practical effect should be greater ability for the debtor to renegotiate debt agreements without filing.

[112] *See, e.g.*, *Bankruptcy Judge Clears $600 Million Financing for Macy*, WALL ST. J., Feb. 14, 1992, at A2 (stating that Macy received interim DIP financing of $60 million just two days after filing for bankruptcy while waiting for court approval for its $600 million DIP financing line).

[113] *See supra* note 31.

[114] Indeed, as previously discussed, the market may demand that they be assumable at the option of the DIP and the bankruptcy court. *See supra* note 31.

after bankruptcy. This clause would mirror the clause in § 365(c)(1) that states that the DIP may not assume or assign an executory contract if "applicable law excuses a party, other than the debtor"[115] and "such party does not consent to such assumption or assignment," but would be included to operate prepetition.[116] Thus, unlike the exception in § 365(c)(1) which allows a creditor to consent postpetition after being excused by applicable law, the new amendment would override § 365(c)(2) if the creditor consented prepetition. (Consent postpetition is not necessary as that is congruent with renegotiation under the current § 365(c)(2)). This new language therefore would deny exclusion under § 365(c)(2) if the creditor consented to such assumption.[117]

Such a change would satisfy the policies of bankruptcy law as well as the external policies of contract law because third-party creditors would still be protected by the requirements in § 365(a) of court approval.[118] The creditor in privity would be well aware of any risk that it was incurring, and the DIP would then be in a position to choose whether the executory contract was in its best interests after filing for bankruptcy. Moreover, such a clause would permit a debtor to weigh the relative benefits of rehabilitation either through or outside of bankruptcy. Finally, the amendment would create added leverage for debtors to apply in their prepetition negotiation with creditors, thereby promoting the desired arms-length renegotiation and solutions outside of bankruptcy.

Acceptance of this proposed amendment to § 365(c)(2) would also necessitate a reexamination of § 365(e).[119] Section 365(e) generally prohibits the use of *ipso facto* clauses:

> Notwithstanding a provision in an executory contract . . . an executory contract or unexpired lease of the debtor may not be terminated or modified . . . solely because of a provision in such contract or lease that is conditioned on . . . the insolvency or

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[115] 11 U.S.C. § 365(c)(1)(A).

[116] *Id.* § 365(c)(1)(B).

[117] Moreover, because of the peculiarities of DIP financings, it would seem absurd to permit assumption and assignment by the DIP, and the Code should clearly indicate that, notwithstanding other provisions under the Chapter, assumption does not permit assignment by the DIP unless the creditor also explicitly consented to such assignment.

[118] *See* 11 U.S.C. § 365(a)(1988) (stating that the DIP "subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor").

[119] 11 U.S.C. § 365(e).

financial condition of the debtor at any time before the closing of the case.[120]

There is an exception, however, to the general rule against *ipso facto* clauses found in § 365(e)(2)(B) that upholds the validity of *ipso facto* clauses in financial accommodation contracts.[121] In conjunction with the current literal reading of § 365(c)(2), which denies assumption of executory financial accommodation contracts anyway, § 365(e)(2)(B) is, at best, added protection to cautious creditors and at worst, superfluous. Under the proposed change of § 365(c)(2), however, § 365(e)(2)(B) would get new life, as cautious creditors could protect themselves from court perceived consent through the inclusion of an *ipso facto* clause. That is, DIP financiers with sufficient market power could protect themselves from assumption simply by including an *ipso facto* clause in their caveats. This scenario would frustrate the purpose of the § 365(c)(2) amendment by leading to a preposterous conflict in DIP financing agreements: one covenant would require the filing of bankruptcy by the debtor as one of many preconditions to the extension of credit,[122] while another covenant would void the contract upon the debtor's filing for bankruptcy. It is unclear whether a court presented with such facts would simply ignore the two clauses, or would hold that the *ipso facto* clause overrides the clear consent implied in the covenant requiring the filing of bankruptcy. By amending § 365(e)(2)(B) to mirror the consent language in § 365(e)(2)(A),[123] the Code will clearly indicate that § 364 DIP financing that is agreed to prepetition is assumable by the DIP.[124]

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[120] *Id.* §§ 365(e)(1)(A).

[121] *See id.* § 365(e)(2)(B) (stating that the rule against *ipso facto* clauses does not apply if "such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor").

[122] Other caveats might include the requirement that the court affirm the DIP financing plan.

[123] In light of the way that § 365(e)(2)(A) and (B) match the provisions of § 365(c)(1) and (2), it is clear that an amendment to § 365(c)(2) also requires an amendment to § 365(e)(2)(B). Section 365(e)(2)(A) states that *ipso facto* clauses will not be refused if applicable law excuses the other party to the contract and "such party does not consent to such assumption." 11 U.S.C. § 365(e)(2)(A)(ii). Arguably, the same requirement should be included in § 365(e)(2)(B).

[124] The discussion regarding amendment of § 365(c)(2) provides an interesting basis for the examination of the expanded use of DIP financing agreements prepetition. The recent trend of prepackaged bankruptcies is perhaps the most obvious area for prepetition innovation. Whereas it may

IV. CONCLUSION

While some readers may consider some of the arguments made in this Comment radical, the overarching proposal for an amendment to the Bankruptcy Code is a simple and practical response to the needs and practices of the current DIP financing market. The great divergence of bankruptcy courts' interpretations of § 365(c)(2) indicates that a literal § 365(c)(2) may be obsolete in the current business bankruptcy environment, at least to the extent of its interaction with § 364 DIP financing that is agreed to prepetition. Unless § 365(c)(2) is amended, debtors and creditors alike will be subject to arbitrary and unpredictable ad hoc court interpretations of how § 365(c)(2) should be applied. For companies that are struggling to decide what form of reorganization will maximize value for all stakeholders, whether they be creditors or shareholders, the amendment of § 365(c)(2) to include consent language like that

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already be common practice in the current market to include DIP financing agreements in creditor negotiations of prepackaged plans, Lang Interview, *supra* note 20, there is no specific rule that permits prepetition confirmation by creditors of § 364 financing. In fact, under Bankruptcy Rule 4001(c)(2), *see* FED. R. BANKR. P. 4001(c)(2), while interim financing may be received earlier by the debtor, the bankruptcy court is not even authorized to commence hearings for fixed DIP financing until at least 15 days after the motion for financing has been served. *See id.*

In practice, prepackaged negotiations often include DIP financing as part of the proposed reorganization, Lang Interview, *supra* note 20, and creditor acceptance acts as *de facto* acceptance of the financing before filing so that hearings will be as swift as possible postpetition. This practice promotes efficiency and seems to have statutory basis to the extent that DIP financing is an important part of a prepackaged plan and to the extent that §§ 1126 and 1129 authorize these prepetition agreements for plans of reorganization. *See* 11 U.S.C. §§ 1126(a) (authorizing holders of claims to accept or reject reorganization plans), 1129(a) (providing for court confirmation of such plans).

Moreover, there has been an increasing emphasis placed on the value of these prepetition agreements with creditors as is evident in the new movement for instant bankruptcies. *See generally* Case & Harwood, *supra* note 13 (discussing the use of the Federal Declaratory Judgment Act to speed the bankruptcy confirmation process). It therefore seems only practical that DIP financings with the same notice and confirmation requirements as prepackaged plans that can be agreed upon by creditors prepetition ought to be assumable by the DIP without the costly and lengthy hearing process that is contemplated under the current Code.

Clearly, this proposal is simply intended as a brief sketch of the new direction that the Bankruptcy Code could take if § 365 is amended. Whereas this proposal presents complicated problems that cannot be addressed here, the benefits it would provide in terms of reduced costs and time would seem to merit serious consideration.

found in § 365(c)(1) (along with the concurrent amendment of § 365(e)(2)(B)) would provide clear guidance that reliance on prepetition agreements for DIP financing is a predictable means for weighing some of the value of filing for Chapter 11 protection.

This Comment has repeatedly argued that the innovations offered herein are actually not innovations at all. Indeed, the market for DIP financing practically performs all of the suggested amendments without the benefit of the express statutory blessings of the Code. However, the mere fact that the market forces that currently exist allow the market to act effectively in spite of the Code should offer little consolation. Given the incredible financial changes that have taken place over the last decade, it is not clear that these market conditions will persist. The only way to explicitly recognize the valuable practices developed in the market and to provide assurance to debtors is to make the law conform to these practices through clear amendments to the Bankruptcy Code.